Supply of Money

There are several definitions of the **supply of money.** *M*1 is narrowest and most commonly used. It includes all **currency** (notes and coins) in circulation, all **checkable deposits** held at banks (bank money), and all **traveler's checks.** A somewhat broader measure of the supply of money is *M*2, which includes all of M1 plus **savings** and **time deposits**held at banks. An even broader measure of the money supply is *M*3, which includes all of *M*2 plus large denomination, long-term time deposits—for example, **certificates of deposit** (CDs) in amounts over $100,000. Most discussions of the money supply, however, are in terms of the *M*1 definition of the money supply.

Banking business. In order to understand the factors that determine the supply of money, one must first understand the role of the **banking** sector in the money-creation process. Banks perform two crucial functions. First, they receive funds from depositors and, in return, provide these depositors with a checkable source of funds or with interest payments. Second, they use the funds that they receive from depositors to make loans to borrowers; that is, they serve as **intermediaries** in the borrowing and lending process.

When banks receive deposits, they do not keep *all* of these deposits on hand because they know that depositors will not demand all of these deposits at once. Instead, banks keep only a *fraction* of the deposits that they receive. The deposits that banks keep on hand are known as the banks' **reserves.** When depositors withdraw deposits, they are paid out of the banks' reserves. The **reserve requirement** is the *fraction* of deposits set aside for withdrawal purposes. The reserve requirement is determined by the nation's banking authority, a government agency known as the **central bank.** Deposits that banks are not required to set aside as reserves can be lent to borrowers in the form of **loans.** Banks earn **profits** by borrowing funds from depositors at zero or low rates of interest and using these funds to make loans at higher rates of interest.

A **balance sheet** for a typical bank is given in Table . The balance sheet summarizes the bank's **assets** and **liabilities.** Assets are valuable items that the bank owns and consist primarily of the bank's reserves and loans. Liabilities are valuable items that the bank owes to others and consist primarily of the bank's **deposit** liabilities to its depositors. In Table , the bank's assets (reserves and loans) total $1 million. The bank's liabilities (deposits) total $1 million. A banking firm's assets must always equal its liabilities.

TABLE 1 The Balance Sheet of A Typical Bank

Assets		Liabilities	
Reserves	$100,000	Deposits	$1,000,000
Loans	900,000		

You can infer from Table that the **reserve requirement** in this example is 10%.